

**PSC REGULATION OF MUNICIPAL WATER UTILITIES:
AN OUTLINE FOR CITY ATTORNEYS AND MUNICIPAL UTILITY OFFICIALS**

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I. INTRODUCTION

II. BEFORE *SIMPSON COUNTY WATER DISTRICT*

A. Public Service Commission Act of 1934. [1934 Ky.Acts 580-613](#).

1. “Utility” is broadly defined to include all “persons and corporations or their lessees, trustees or receivers that now or may hereafter own, control, operate or manage” utility facilities.

a. Corporation includes “private, quasi public and public corporations.”

b. Cities are not specifically mentioned, but fall within the definition of utility by virtue of being a public corporation and owning utility facilities.

2. PSC Granted the Authority to Change Rates - § 4(n).

The commission shall have power, under the provisions of this act, to enforce, originate, establish, change, and promulgate any rate, rates, joint rates, charges, tolls, schedules or service standards of any utility, subject to the provisions of this act, that are now fixed or that may in the future be fixed, by any contract, franchise or otherwise, between any municipality and any such utility, and all rights, privileges and obligations arising out of any such contracts and agreements regulating any such rates, charges, schedules or service standards, shall be subject to the jurisdiction and supervision of the commission; provided, however, that no such rate, charge, schedule or service standard shall be changed, nor any contract or agreement affecting same shall be abrogated or changed until and after a hearing has been had before the commission in the manner prescribed in this act.

Nothing in this section or elsewhere in this act contained is intended or shall be construed to limit or restrict the police jurisdiction, contract rights, or powers of municipalities or political subdivisions, except as to the regulation of rates and service, exclusive

jurisdiction over which is lodged in the Public Service Commission.

3. Purpose of § 4(n).

a. Act effectively stripped municipalities from regulating utility rates through their franchising authority. “The power to regulate rates had been delegated to the city by the Legislature, and what it had given it could take away. The act of 1934 which created the Public Service Commission divested the city of the power to regulate rates and reposed that power in the Commission. [Southern Bell Telephone & Telegraph Co. v. City of Louisville](#), 265 Ky. 286, 96 S.W.2d 695, 698 (1936).

b. It was the intention of the Legislature “to clothe the Public Service Commission with complete control over rates and services of the utilities enumerated in the act” *Id.* at 697 (1936).

4. Municipal Opposition.

a. Act viewed as a threat to home rule and seen as stripping local control of utilities away from cities. Opposing the legislation, Neville Miller, then mayor of Louisville, declared that by making the Louisville Water Company subject to the Commission’s jurisdiction, it would amount to “putting control of the Louisville Budget in the hands of a State commission.” [Miller Against Utilities Body](#), *Courier Journal*, Feb. 15, 1934 at A1.

b. Strong opposition in Louisville where the Louisville Public Utilities Bureau regulated utility rates and City directly established Louisville Water Company rates.

c. “As far as municipal plants are concerned, where these are publicly owned, no regulating body set up at the State capital should be given the slightest authority over them.” [Not a Good Bill](#), *Courier Journal*, Feb. 16, 1934 at A6 [Editorial].

d. Concerns that the commission would become the captive of investor-owned utilities. Opponents contended that it was easier to corrupt 3 persons in Frankfort than the entire membership of a city council. Opponents also noted that no regulated utility opposed the proposed law.

e. Efforts made to exempt municipal utilities from Commission jurisdiction, but fail in both House and Senate.

B. 1936 Revision to Public Service Commission Act. [1936 Ky.Acts 300-302](#).

1. Definition of “Utility” is revised.

Provided, however, that for the purposes of this act the term “utility” or “utilities” shall not mean or include any city or town or water districts established in pursuance of Chapter one hundred thirty-nine (139), Acts one thousand nine hundred twenty-six (1926) and amendments thereto, owning, controlling, operating or managing any facility or facilities enumerated in this paragraph.

2. Municipal utilities expressly excluded from the definition of utility.

3. Principal reasons for amendment.

a. Remove conflict with municipal utility acquisition/construction statute.

(1) 1932 Act permitted second class cities to purchase, establish, and operate electric plants. Public Service Commission Act of 1934, by allowing PSC to regulate municipal utility rates, effectively modified the 1932 Act.

(2) Legislature revised 1932 Act to permit second through sixth-class cities to purchase, establish, and operate electric plants. Further provided that all laws and parts of laws in conflict with 1932 Act were repealed. Effectively repealed utility definition provisions.

(3) Legislature expressly rejected efforts to require municipal utilities to obtain a certificate of public convenience and necessity before

b. Concern that PSC would prevent competition with private investor utilities by municipal utilities. Captive PSC would refuse to issue certificates.

c. Concerns of the City of Louisville regarding the Louisville Water Company.

4. Revision does not affect requirement to obtain a certificate. [City of Vanceburg v. Plummer, 275 Ky. 713, 122 S.W.2d 772 \(1938\)](#).

[The amendment to 1934 Act] only divested the Public Service Commission of supervisory and regulatory power

over plants owned and operated by municipalities, and **left in effect the requirement that a municipality must obtain from the commission a certificate of convenience and necessity before it can begin the construction of a plant.**

After a city has obtained a certificate and constructed a utility plant, it can operate the plant and fix the rates for the utility commodity through its city utility commission free from any supervision or regulation by the State Public Service Commission. The chief purpose of the requirement in the Public Service Commission Act, that a certificate of convenience and necessity be obtained from the Public Service Commission before construction of a utility plant is begun, is to prevent the unnecessary duplication of facilities for utility service and to protect the consuming public from inadequate service and higher rates which frequently result from such duplication. The reason for the requirement applies alike to municipally and privately owned utilities. The Legislature recognized the public evil which results from unlimited competition in the public utility field, and placed this provision in the act as a safeguard against it, and we find nothing in the amendment to the 1934 Act which indicates that the Legislature intended to remove that safeguard so far as municipally owned utilities are concerned.

C. Jurisdiction over retail operations outside of a city's boundaries.

1. *Olive Hill v. Public Service Commission*, 305 Ky. 249, 203 S.W.2d 68 (1947).

a. City was providing electric service outside the city limits. Customers dissatisfied with service petitioned PSC to permit them to obtain service from another supplier. They alleged, *inter alia*, that City furnishing inadequate service at excessive rates. PSC ordered City to show cause why it had the authority to provide service outside its boundaries and two neighboring utilities to show cause why they should not be required to extend their lines to provide service to the complaining customers. After holding a hearing, PSC found that the City did not have the legal authority to serve outside its boundaries, directed the City to cease providing the service and directed the neighboring utilities to extend service to the complaining customers.

b. City brings action for review in Franklin Circuit Court. PSC's action upheld. Appeal to Court of Appeals.

c. Held:

(1) PSC does not have the authority to determine whether a city may provide service outside its boundaries.

(2) “When the City supplied current outside its corporate limits, its exemption from regulation as to rates and service by the Commission ceased, and the City came within the jurisdiction of the Commission and was subject to such regulation by it.”

d. Rationale.

(1) Not expressly stated.

(2) Legal precedent that Court cites in support of PSC holds that cities when supplying water service are not acting in a governmental capacity but in a proprietary capacity. In such capacity, the city is no more than a private corporation.

2. Followed until 1961.

a. *Louisville Water Company v. Preston Street Road Water District*, 256 S.W.2d 26 (Ky. 1953). Three water districts and two cities brought action seeking declaration that Louisville Water Company’s outside city sales were subject to PSC jurisdiction. Held: *Olive Hill* is determinative. Louisville Water Company’s extra-territorial sales are subject to PSC jurisdiction. Court rejects argument that PSC’s failure to assert jurisdiction since 1936 over these sales is not contemporaneous construction that LWC had right to set rate without PSC approval.

b. *Fraley v. Beaver Elkhorn Water District*, 257 S.W.2d 536 (Ky. 1953) (exempted water district providing gas service outside its boundaries is subject to PSC jurisdiction) (citing *Olive Hill*).

c. *City of Covington v. Sohio Petroleum*, 279 S.W.2d 746 (Ky. 1955). Held: The establishment of utility rates for nonresident consumers of a municipally owned utility is within the jurisdiction of the Public Service Commission. Expressly rejected argument that enactment of *KRS Chapter 106*, which provided that PSC would not have any jurisdiction over water system that a municipality or water district acquired through condemnation or purchase, exempted municipal utilities from PSC jurisdiction.

d. *City of Richmond v. Public Service Commission*, 294 S.W.2d 513 (Ky. 1956). Richmond sold water and gas to non-residents. Non-resident customers constructed and owned distribution facilities and meters that are located outside city boundaries. City read meters and billed customers. Customers sought PSC review of rates. Denying complaint, PSC held it lacked jurisdiction since none of city's facilities were outside city. Held: Transactions occur outside city boundaries and are subject to PSC jurisdiction.

e. *Louisville Water Company v. Public Service Commission*, 318 S.W.2d 537 (Ky. 1958). Held: Although cities authorized to serve 5 miles beyond their limits, this authorization did not limit or alter PSC jurisdiction to regulate the rates for service provided within that 5-mile zone.

3. Reasoning behind PSC Jurisdiction.

a. Legal. City ceases to be city when it provides services outside its borders.

A. Political. Non-residents are without power to influence city policymakers.

Residents of a city have some means of protection against excessive rates or inadequate service of a utility owned by the city, through their voting power. However, customers outside the city have no such means of protection, and unless their interests are protected by the Public Service Commission they are at the mercy of the utility. This consideration, we think, was the basis for the decisions that the legislature did not intend to exempt municipally owned utilities from regulation in rendering service outside the city.

Louisville Water Company v. Public Service Commission, 318 S.W.2d 537, 539-540 (Ky. 1958).

4. *McClellan v. Louisville Water Company*, 351 S.W.2d 197 (Ky. 1961).

a. Louisville Water Company ("LWC") had substantially increased its non-resident rates in 1939 and 1946 without PSC approval. In 1956 LWC decreased the discount provided to non-resident customers. LWC customers who lived outside Louisville's city limits brought an action in Jefferson Circuit Court to have

LWC's non-resident rates declared void, to enjoin LWC from collection of non-residential rates, and to require LWC to refund unlawful rates. Jefferson Circuit Court rendered judgment for LWC. Customers appealed to Court of Appeals.

b. Held: Court's prior interpretation of [KRS 278.010\(3\)](#) is erroneous. The exemption provided in [KRS 278.010\(3\)](#) "extends to all operations of a municipally owned utility whether within or without the territorial boundaries of the city." *Olive Hill* is overruled. "While we recognize that this decision deprives nonresident utility customers of the protection afforded by the Public Service Commission against excessive rates or inadequate service, nevertheless matters of this character are of legislative rather than judicial concern."

D. Requirement for Municipal Utilities to Obtain a Certificate of Public Convenience and Necessity

1. [City of Vanceburg v. Plummer, 275 Ky. 713, 122 S.W.2d 772 \(1938\).](#)

2 [City of Covington v. Public Service Commission, 327 S.W.2d 954 \(Ky. 1959\).](#) Newport and Covington supply water to Campbell County WD. Newport proposed to replace its obsolete water treatment plant with a larger size plant that would enable it to supply its needs and WD's total requirements. Newport and WD entered 40-year water supply contract for Newport to supply total requirements. Newport applies to PSC for a certificate or, in the alternative, for disclaimer of jurisdiction. PSC finds that new plant will result in duplication of facilities, that it lacks jurisdiction over contract between Newport and WD, and that public convenience and necessity require construction of facilities. Affirming PSC decision, Court of Appeals finds that PSC had jurisdiction based upon *City of Vanceburg* but notes problems with limited PSC jurisdiction. ("The exercise of authority by the Commission to approve or disapprove the erection of a city water plant is fraught with many difficulties since the Commission clearly has no jurisdiction over the rates, services or contracts of the utility (see [KRS 278.010\(3\)](#), [278.020\(1\)](#), and [278.040](#)), and because, as in cases such as the present, several classes of water consumers, with conflicting interests, may be involved.")

3. [City of Cold Springs v. Campbell County Water District, 334 S.W.2d. 269 \(Ky. 1960\).](#) Declaratory judgment action involving a dispute between Campbell County WD and Covington over service to an area within WD's territory. Lower court holds that water district had exclusive right to serve in its territory. Reversed on appeal. Court of Appeals finds no exclusive right to serve and that it was responsibility of PSC to

determine who should be authorized to construct facilities to serve the area in question. (“Clearly in a case such as the one before us, the Commission is pre-eminently qualified to determine which of these two competing political subdivisions is best qualified to, and should serve the Johns Hill area. That is the business of the Commission, and is not a matter for the original jurisdiction of courts.”)

3. *City of Georgetown v. Public Service Commission, Ky., 516 S.W.2d 842 (1974).*

a. Facts: City of Georgetown sought to extend its water system outside its city boundaries. Kentucky-American Water Company (“KAW”) filed a complaint with PSC in which it alleged that City’s proposed facilities would enable it to serve within KAW’s service territory. Arguing that the PSC had lacked jurisdiction over it, City moved to dismiss the complaint. PSC denied motion. City filed an action for declaration of rights and injunctive relief. Franklin Circuit Court denied the motion for injunctive relief. City appealed.

b. Positions:

(1) PSC/Kentucky American: [KRS 278.020\(1\)](#) refers to “person,” not to “utility”. *McClellan* holding therefore is not applicable.

(2) City: [KRS 278.010\(3\)](#) clearly exempts cities from PSC jurisdiction. *McClellan* cited in support.

c. Holding: Reverses lower court. “It would be entirely inconsistent with the *McClellan* ruling to require a municipal water plant to obtain a certificate from the Commission It is our view that the plain intent of the General Assembly as expressed in KRS 278.010(1) should prevail and should not be circumscribed by a strained reasoning process bringing into play KRS 278.020(1).”

III. ***Simpson County Water District Decision***

A. Facts:

1. In 1967 Simpson County Water District (“Simpson District”) and City of Franklin, Kentucky (“Franklin”) enter a water purchase agreement. Franklin would provide Simpson District’s water requirements (up to 20MGD) for a period of 45 years. Contract specifies a rate of \$.21 per 1,000 gallons but permitted Franklin to adjust rate. If Franklin increases the rates to **each of its customers**, the contract rate to Simpson District is increased by the same percentage increase to Franklin’s customers.

2. In 1982 Franklin and Simpson District negotiate a Supplement Agreement. Changes are made to quantity and billing provisions. All other provisions are reaffirmed.

3. In 1986 Second Supplement Agreement is executed. Agreement is necessary to construct a new water treatment plant “to provide larger quantities of water to all of its customers, including the District.” Under the terms of Agreement, Simpson District agrees to pay a share of the debt service on municipal bonds that will be issued to finance the new plant’s construction in exchange for increased quantity of water.

a. The new rate is \$0.8478 per 1,000 gallons. It becomes effective on the first month following the issuance of revenue bonds. This rate remains in effect and **is not subject to change** for 5 years. Franklin may change rate within the 5-year period “should it be necessary for the City to increase its rates to **each of its customers solely because of debt service obligations on long-term financing for construction of raw water supply improvements to the City’s water treatment plant.**”

b. After 5 years Franklin may automatically increase the rate to Simpson District if it increases its rates to each of its customers. Rate of increase to Simpson District will be the “same percentage as that percentage increase charged such customer of the City, whose rate is increased the small percentage.”

4. In June 1990 Franklin raises its rate to Simpson District from 84.78 cents per 1,000 gallons to \$1.3478 per 1,000 gallons. It also raised rates to its retail customers. Simpson District refuses to pay increase and continues to pay \$.8478 per 1,000 gallons.

5. On May 13, 1991 Franklin raised its rate to Simpson District from \$1.3478 to \$1.68 per 1,000 gallons. No change is made to city resident rates. Simpson District refuses to pay increase and continues to pay \$.8478 per 1,000 gallons.

6. In discussions with Franklin, Simpson District relies upon the recent decision in *City Utility Commission of Owensboro v. East Daviess County Water Association* (Daviess Cir. Ct. Ky. April 2, 1991). Unpublished opinion holds that before a city’s contract with a utility can be changed or modified a hearing before PSC must be held.

7. On May 21, 1991, Franklin requests an opinion from PSC on the need for PSC approval of its rate change. In its request for opinion, Franklin sets forth both parties’ positions.

8. On June 12, 1991, PSC, through its Executive Director, responds:

You are correct that the City, as a municipal utility, is specifically exempted by KRS 278.010(3) from Commission jurisdiction. (See also [McClellan v. Louisville Water Co. et al.](#), (1961) 351 S.W.2d 197; [Foley v. Kinnett et al.](#), (1972) 486 S.W.2d 705; and [City of Georgetown v. Public Serv. Comm'n](#) (1974) 516 S.W.2d 842. **As the city is exempt from Commission jurisdiction, the Commission has no authority to regulate its rates.**

. . .

It is unclear from your letter what grounds the District relies upon to support its position that the City must obtain Commission approval for an increase in rates. As stated above, pertinent statutes and case law appear to be clear on this matter; nonetheless, if the District relies upon other legal authority, it is welcome to submit its position to the Commission for consideration. However, if the City and District are unable to resolve this matter informally, it does not appear that the Commission could provide an official forum in which to entertain the dispute. KRS 278.260 endows the Commission with jurisdiction over complaints as to rates or service of any utility. However, **the City is not a utility within the definition of KRS Chapter 278, and it is clear that the statute would logically apply only to utilities over which the Commission has jurisdiction.**

[Letter from Lee M. MacCracken, Executive Director, PSC, to Timothy J. Crocker, Attorney for City of Franklin \(June 12, 1991\)](#) (emphasis added).

9. On August 21, 1991, Franklin brings suit to collect unpaid charges and to have its contracts with Simpson District declared void.
10. Simpson District moves for dismissal of action for lack of jurisdiction.

B. Simpson Circuit Court Proceeding.

1. Simpson District's Argument:

a. Franklin's actions constituted a change in the rate and service conditions fixed by the three previous agreements between

Simpson District and Franklin. Jurisdiction over Franklin's actions rests exclusively with the PSC.

- b. Since the statutory definition of "utility" excludes a city, a city is not subject to regulation by PSC **except with regard to the "regulation of rates and service of utilities."**

The jurisdiction of the commission shall extend to all utilities in this state. The commission shall have exclusive jurisdiction over the regulation of rates and service of utilities, but **with that exception** nothing in this chapter is intended to restrict the police jurisdiction, contract rights or power of cities or political subdivisions.

[KRS 278.040\(2\)](#) (emphasis added).

- c. [KRS 278.200](#) provides that PSC has jurisdiction over any rate or service standard contained in an agreement between a city and any utility and that no such rate or service standard may be changed without first having a hearing before the PSC.

The commission may, under the provisions of this chapter, originate, establish, change, promulgate and enforce any rate or service standard of any utility that has been or may be fixed by any contract, franchise or agreement between the utility and any city, and all rights, privileges and obligations arising out of any such contract, franchise or agreement, regulating any such rate or service standard, shall be subject to the jurisdiction and supervision of the commission, but no such rate or service standard shall be changed, nor any contract, franchise or agreement affecting it abrogated or changed, until a hearing has been had before the commission in the manner prescribed in this chapter.

[KRS 278.200](#).

- d. Simpson District introduces and relies upon *City of Owensboro* decision.

2. Franklin's Argument:

- a. *McClellan* is controlling. The PSC has no jurisdiction over a city's rates.

b. Franklin introduces PSC's response to its inquiry about PSC jurisdiction.

3. Court's Decision (Nov. 12, 1991):

a. Emphasis placed upon the rates and service exception within [KRS 278.040\(2\)](#).

b. "KRS 278.200 seeks to address those instances where a contract has been made between a utility and a city. . . . [I]t merely provides that where a city and a utility enter into a contract, the terms of which include provisions for rates and services, then by so contracting the City gives up its exemption from PSC regulation and renders itself subject to regulation by the PSC." [City of Franklin v. Simpson County Water District, No. 91-CI-00184 \(Simpson Cir. Ct. Ky. Nov. 12, 1991\)](#) at 5 – 6.

c. "KRS 278.200, read together with KRS 278.040(2) creates what has been called a 'rates and services' exception to a city's exemption from PSC regulation." *Id.*

d. Court refused to strike references to *City of Owensboro* decision. "While the Court finds same to be well-reasoned and articulate, they neither strengthen nor weaken this Court's reasoning and conclusions . . . and they have not swayed the Court either way in its disposition of the pending motion." *Id.* at 9.

C. Kentucky Court of Appeals' Opinion (Jan. 8, 1993).

1. Franklin appeals Simpson Circuit decision. Court of Appeals reverses on a 2-1 decision.

2. Majority Position:

a. Absent a clear indication by the Legislature to the contrary, the term "utility" should be given uniform meaning throughout Chapter 278. Accordingly, absent clear evidence of a contrary intent, the City should not be deemed a utility while interpreting [KRS 278.040\(2\)](#).

b. The exception clause of [KRS 278.040\(2\)](#) cannot come into play unless the general jurisdictional clause to which it refers is applicable. The dispute in the present case concerns the price of treated water charged by a city to a utility-customer. As a city is by

definition not a utility, the general clause is not applicable and the exception does not come into operation.

c. Trial Court ignores the definition of “rate” and “service.” “As the definition of ‘rate’ refers to the term ‘utility’, then the contractual price of treated water sold by the City cannot be considered a ‘rate’ because the City is not within the definition of a ‘utility.’ “

"Rate" means any individual or joint fare, toll, charge, rental, or other compensation for service **rendered or to be rendered by any utility**, and any rule, regulation, practice, act, requirement, or privilege in any way relating to such fare, toll, charge, rental, or other compensation, and any schedule or tariff or part of a schedule or tariff thereof;

[KRS 278.010\(12\)](#) (emphasis added).

"Service" includes any practice or requirement in any way relating **to the service of any utility**, including the voltage of electricity, the heat units and pressure of gas, the purity, pressure, and quantity of water, and in general the quality, quantity, and pressure of any commodity or product used or to be used for or in connection with the business of **any utility**;

[KRS 278.010\(13\)](#) (emphasis added).

d. Trial Court’s interpretation would make KRS 278.015(2) meaningless. “There would be no need for such a provision if the City, acting as a wholesale supplier to the District, were precluded from raising its prices under KRS 278.040(2).” [City of Franklin, Ky. v. Simpson County Water District](#), No. 91-CA-002675-MR (Ky.App. Jan. 8, 1993) at 5.

e. Trial Court’s reliance on [KRS 278.200](#) is mistaken. References to rate and service refer to rates and service of a utility, not a city. “[I]t would not apply to the City’s action as the City is not a “utility,” nor does the action involve a “rate” or “service.” *Id.* at 6. Rate or service standard “can only refer to a “utility” and does not encompass the operations of the City when it acts as a wholesale supplier of water to the District.” *Id.*

f. Purpose of [KRS 278.200](#) is to prevent a city from usurping powers which the Legislature granted to the PSC to regulate rate

and service standards of its utility-supplier by means of a contract, franchise or agreement.

g. If Legislature had intended to depart from the statutory definition of a utility and place cities acting as suppliers to utilities within the exclusive jurisdiction of the PSC it could have done so by writing statute as granting exclusive jurisdiction to the PSC over “rates and services of all utilities including cities.” It did not.

3. Dissenting Opinion:

a. The rates and service exception is intended to prohibit cities from exercising any control whatsoever over the rates charged and the services provided to customers of local utilities, as jurisdiction over the regulation of such rates and services is exclusively vested in the PSC.

b. Doubling of rates by Franklin within a 2-year period unquestionably affected utility's rates and services, thereby amounting to the city's exercise of a power reserved exclusively to the PSC.

c. PSC's jurisdiction was intended to exclusively encompass any action, including that taken by a city or other governmental entity, which “in any way” relates to or affects rates and services “rendered or to be rendered” by a utility.

D. PSC Proceeding.

1. On March 4, 1992, Franklin filed a petition and complaint with the PSC.

2. Relief Sought:

a. Declaration that Franklin had the right and authority to increase its wholesale rates to Simpson District.

b. Authorization for a purchased water adjustment to Simpson District to increase the water district's rates.

c. Imposition of a surcharge on Simpson District's customers to permit recovery of all water costs from the date that Franklin first imposed the rate increases.

d. Order directing Simpson District to pay the surcharge revenues to Franklin and to pay the increased Franklin rates.

e. (Alternatively Pleaded) If PSC has jurisdiction over Franklin's rates, then an Order approving a rate adjustment from \$.8478 to \$1.68 per 1,000 gallons of water and imposing a surcharge on Simpson District's retail rates to recover lost wholesale revenues.

3. Simpson District's Response: PSC lacks jurisdiction and should dismiss the Complaint. In the alternative, PSC should hold proceeding in abeyance pending completion of appeals of Simpson Circuit Court decision.

4. PSC Decision (May 26, 1992).

a. Key Issue: Does PSC have jurisdiction over the rates charged by Franklin?

b. Holding: No jurisdiction.

KRS 278.010(3) defines a utility as any person except a city, who owns, controls, or operates or manages any facility used to provide water to the public for compensation. Franklin is an incorporated city in Simpson County, Kentucky, which owns and operates a municipal water plant under the provisions of KRS Chapter 96. As a municipality, the city is specifically exempted from Commission jurisdiction under KRS Chapter 278, thus, the Commission has no authority to regulate Franklin's rates. The relief requested by Franklin – that the Commission declare Franklin had the right and authority to increase its rates or, alternatively, that Franklin's rate increase be approved, cannot be granted.

City of Franklin v. Simpson County Water District, Case No. 92-084 (Ky. PSC May 26, 1992) at 3-4.

c. PSC dismisses Complaint.

5. Franklin Circuit Court affirms PSC Decision. *City of Franklin v. Kentucky Pub. Serv. Com'n*, No. 92-CI-00850 (Franklin Cir. Ct. Ky. April 21, 1993). Holds that PSC acted properly in deferring any decision pending completion of other proceedings pending before the Court of Appeals.

E. [Supreme Court Opinion \(Jan. 31, 1994\).](#)

1. Supreme Court reverses Court of Appeals Opinion (4-3).
2. Majority Opinion:
 - a. Recognizes a “rates and service exception” to the statutory exemption of municipalities from PSC regulation. Refers to [KRS 278.040\(2\)](#). “The legislature has conferred upon cities an exemption from the PSC’s power to regulate local utilities in every area except as to rates and service.” [Simpson County Water Dist. v. City of Franklin](#), 872 S.W.2d 460, 462 (Ky.1994).
 - b. Rejects argument that [KRS 278.200](#) applies only to contracts where the utility is providing service to a city. “[T]he statute makes no such distinction. The statute has but one meaning – the City waives its exemption when it contracts with a regulated utility upon the subjects of rates and service.” *Id.*
 - c. “[W]here contracts have been executed between a utility and a city, . . . KRS 278.200 is applicable and requires that by so contracting the City relinquishes the exemption and is rendered subject to PSC rates and service regulation.” *Id.* at 463.
 - d. Distinguishes *McClellan* by noting that at the time of the issuance of that opinion, water districts were not subject to PSC jurisdiction.
 - e. Statutory exception is viewed as mechanism to protect “public utilities” from municipal utilities:

The statutory exception applicable to rates and service as provided will prohibit cities from exercising control over rates charged and the service provided to customers of local utilities. Jurisdiction to regulate such rates and service has been exclusively vested in the PSC. The record in this case discloses a doubling of the wholesale water rates charged to the District within a two-year period, with a direct impact upon the District’s utility rates and service. Added to the force which the City sought to apply was a call to terminate service by declaring the parties’ contract null and void. It is apparent that the City, through its enhanced water sale ordinances, did not direct the setting of any particular rate schedule, but its action profoundly and directly impacts the District’s general revenue level,

which is one of the first steps in rate making. **The City's action is an improper engagement in rate making and strongly supports PSC jurisdiction. The statutory definition of utility is not to serve as an impenetrable shield to afford the City immunity.**

. . .

The rates and service exception effectively insures, throughout the Commonwealth, that any water district consumer/customer that has contracted and become dependent for its supply of water from a city utility is not subject to either excessive rates or inadequate service.

Id. at 464.

f. Notes that a contract between municipal utility and public utility will always exist where a sale occurs. Further notes that in such instances PSC will always have jurisdiction. "Once established by contract such service can only be abrogated or changed after a hearing before the PSC." *Id.* at 465.

3. Dissenting Opinion:

a. The PSC has jurisdiction only over the rates and services of a "utility," publicly or privately owned as distinguished from city-owned.

b. Purpose of § 4(n) of [PSC Act of 1934](#) was not to grant the PSC jurisdiction over the rates of city-owned utilities, rather the statute was intended to transfer jurisdiction to the PSC over public utility rates which had been fixed initially by a city at the time a utility franchise was granted.

c. Historical background does not support majority's position. Prior to adoption of the PSC Acts, cities regulated the rates charged by utilities for services inside the city limits. In exercising its power to grant a franchise to use the public streets, a city could establish a utility's initial rates in the franchise agreement. During the existence of the franchise agreement, the city and the utility were free to modify those rates by additional contractual agreement. [KRS 278.040\(2\)](#) merely gave PSC exclusive authority to set those utilities' rates.

d. Terms “rate” and “service” within [KRS 278.200](#) refer only to the rates and service of a jurisdictional utility, not to a city-owned utility.

e. Nothing in the legislative history of KRS Chapter 278 that evidences any attempt for PSC regulation of city-owned utilities.

(1) No legislative attempt to overrule *McClellan*.

(2) No attempt to include cities with water districts when 1964 amendments were enacted.

(3) No need for [1986 Amendments](#) that allow for automatic purchased water adjustment if PSC regulated the wholesale rates of city-owned utilities.

f. [T]he city as a supplier is expressly excluded from the definition of a utility in KRS 278.010(3). In view of the fact that the city is specifically excluded from the definition of a utility in the statute, there is no ambiguity or conflict giving the courts a vehicle to construe the city as subject to PSC regulation and exclude its right to file in circuit court to determine the contractual obligations if any to the Simpson County Water District.

Id. at 467.

F. Conclusion.

1. Based upon *Simpson County Water District*, Court of Appeals reversed PSC’s dismissal of Franklin’s Complaint and remanded to PSC for further consideration. [City of Franklin v. Kentucky Pub. Serv. Com’n, No. 93-CA-001072-S \(May 6, 1994\)](#).

2. Upon remand, PSC found that Franklin had violated [KRS 278.160\(2\)](#) by assessing a rate that was neither on file with PSC nor approved after a hearing. PSC directed Franklin to pay \$196,033 to Simpson District plus interest. [City of Franklin v. Simpson County Water District, Case No. 92-084 \(Ky.PSC Feb. 23, 1996\)](#) at 2.

3. Matter subsequently settled.

4. Simpson District subsequently contracted with another water supplier to furnish its water supply needs.

IV. **IMPLEMENTING SIMPSON COUNTY WATER DISTRICT**

A. Unanswered Questions.

1. What provisions of KRS Chapter 278 apply to municipal utilities?
2. What is the PSC's role – Rate Regulator or Contract Arbitrator?
3. Is the PSC bound by the contract between the municipal utility and the public utility?
4. How does a municipal utility apply for a rate adjustment?
5. How should the PSC establish rates for a municipal utility?
6. What are the limits of PSC jurisdiction

B. Application of KRS Chapter 278 to Municipal Utilities.

1. Filing of Rates and Contracts with PSC.

- a. [KRS 278.160\(1\)](#).

Under rules prescribed by the commission, each utility shall file with the commission, within such time and in such form as the commission designates, schedules showing all rates and conditions for service established by it and collected or enforced. The utility shall keep copies of its schedules open to public inspection under such rules as the commission prescribes.

- b. [Submission of Contracts and Rates of Municipal Utilities, Administrative Case No. 351 \(Ky.PSC Aug. 10, 1994\)](#) (All municipal utilities directed to file their wholesale contracts with public utilities with the PSC).

- c. Commission practice to refuse to permit a municipal utility to place its rates into effect prior to having an effective rate schedule on file with the PSC.

- d. Municipal utilities, not their wholesale customers, had the statutory and regulatory responsibility for submitting the proposed agreement to file contract with PSC. [Winchester Municipal Utilities, Case No. 2001-230 \(Ky.PSC Oct. 19, 2001\)](#).

e. Use of automatic adjustment clauses.

(1) Automatic Adjustments based upon Consumer Price Index rejected. [City of Lawrenceburg, Case No. 2006-00067 \(Ky.PSC Nov. 21, 2006\)](#) (wholesale contract provision that provides for an automatic annual adjustment of wholesale rate based upon increases in the Consumers Price Index not shown to be reasonable or accurate); . PSC questioned the accuracy of the index as it applies to water service and the contract's failure to provide for reductions in rate in the event of deflation.

(2) Detailed formula based upon wholesale suppliers prior year of operations. [Bath County Water District, Case No. 2007-00299 \(Ky.PSC Sept. 26, 2007\)](#). Held: The formula within contract constituted the municipal utility's wholesale rate. This formula did not change. When municipal utility applied the formula to following year's operations, the rate remained unchanged but the product of the formula changed. As rate did not change, [KRS 278.180](#) did not require municipal utility to provide PSC with notice of the "new product", but the better practice was for municipal to advise PSC 30 days in advance of the application of the results of the new calculation.

f. Consequences of failure to file rate schedule or contract.

(1) Refund of improperly collected rates. [City of Franklin v. Simpson County Water District, Case No. 92-084 \(Ky.PSC Feb. 23, 1996\)](#).

(2) Civil Penalty. [City of North Middletown, Case No. 2006-00072 \(Ky.PSC Jan. 12, 2007\)](#).

2. Notice Requirements for Rate Adjustment.

a. [KRS 278.180\(1\)](#): "[N]o change shall be made by any utility in any rate except upon thirty (30) days' notice to the commission, stating plainly the changes proposed to be made and the time when the changed rates will go into effect."

b. [Submission of Contracts and Rates of Municipal Utilities, Administrative Case No. 351 \(Ky.PSC Aug. 10, 1994\)](#) at 2 ("Any municipal utility wishing to change or revise a contract or rate for wholesale utility service to a public utility shall, no later than 30

days prior to the effective date of the revision, file with the Commission the revised contract and rate schedule.”).

c. [807 KAR 5:011](#) requires written notice to wholesale customer.

d. Municipal utility’s failure to comply with notice requirements renders filing void. [North Logan Water District and East Logan Water District v. City of Russellville](#), Case No. 2001-212 (Ky.PSC July 3, 2002); *aff’d* [City of Russellville v. Public Service Commission](#), No. 2003-CA-002132-MR (Ky.App. Feb. 18, 2005).

3. Procedures for applying for rate adjustment (KRS 278.190). [Bowling Green Municipal Utilities](#), Case No. 95-044 (Ky.PSC April 7, 1995) (when applying for a rate adjustment, a municipal utility must comply with the provisions of [KRS 278.190](#) and Administrative Regulation [807 KAR 5:001](#)).

4. Burden of proof in a rate adjustment proceeding.

a. [KRS 278.190\(3\)](#) provides that “[a]t any hearing involving the rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the utility . . .”

b. [City of Franklin v. Simpson County Water District](#), Case No. 92-084 (Ky.PSC Jan. 18, 1996) at 6 (municipal utility’s proposed rate adjustments “are not presumptively valid and reasonable . . . their reasonableness must be adequately demonstrated.”).

5. Time in which to rule upon proposed rate adjustment.

a. [KRS 278.190\(3\)](#) holds that the PSC must decide on the proposed rate adjustment “not later than ten (10) months after the filing of such [rate] schedules.”

b. [City of Warsaw, Kentucky](#), Case No. 99-131 (Ky.PSC Nov. 8, 1999) (stating that [KRS 278.190\(3\)](#) governs the time in which the PSC must rule on proposed municipal rate).

c. [City of Falmouth](#), Case No. 2006-00403 (Ky.PSC June 27, 2007) ([KRS 278.190\(3\)](#) required PSC to act upon municipal utility’s proposed rate schedule within 10 months of filing and PSC’s failure to act within that time period renders the proposed rate schedule effective as a matter of law).

6. Assessment of Penalties for Violations of KRS Chapter 278. [City of North Middletown, Case No. 2006-00072 \(Ky.PSC Jan. 12, 2007\)](#) (Municipal utility assessed a civil penalty pursuant to [KRS 278.990\(1\)](#) for its failure to file its contract and current rate schedules with PSC).

7. Applicability of [KRS 278.023](#) (Rate adjustments required as a condition of a financing agreement with Rural Development (“RD”))

a. [KRS 278.023](#) requires PSC to issue certificate of public convenience and any other orders necessary to implement the terms of an agreement between a water district or water association and the U.S. Department of Agriculture or Department of Housing and Urban Development regarding the financing of a construction project.

b. [Harlan Municipal Water Works, Case No. 2003-00358 \(Ky.PSC Oct. 24, 2003\)](#). City sought a rate adjustment to assess rates that RD required as a condition for financing improvements to city’s water treatment plant. Wholesale customer, a water district, objected and requested PSC review of proposed rate adjustment. Finding that a decision that required lower rates than that specified by the financing agreement would imperil the project, the PSC declined “to impair or impede Harlan’s ability to receive funding” and approved the proposed rate. PSC further found that “although [KRS 278.023](#) does not explicitly apply to cities, our decision herein complies with the policy of the General Assembly as expressed in that statute.”

C. PSC’s Role: Arbitrator or Regulator.

1. Conflicting Models.

a. Arbitrator: PSC merely substitutes for the courts. It applies the terms of the contract to the facts before it. It may not rewrite terms of the contract unless contract law permits. PSC does not sit as a rate-making authority when adjudicating contract issues.

b. Regulator: By contracting with a public utility, the municipal utility loses its exemption from PSC regulation. It thus becomes a utility and is subject to PSC’s authority to charge rate and service provisions within the contract. PSC may change the terms that result in unjust, unreasonable, or unfair rates or conditions of service.

2. Arbitrator Role – PSC acts only when the parties are in dispute.

a. Unlike a public utility's request for rate adjustment, where a formal review is always conducted, the PSC generally has not conducted a formal review of a municipal utility's proposed rate adjustment unless the affected wholesale customer or other interested party files an objection or otherwise requests a formal review. The PSC's tendency not to formally investigate municipal rate proposals in the absence of such requests suggests that where parties are in agreement, PSC sees no pressing need to act.

b. Limited filing requirements for municipal utilities. In comparison with public utilities, municipal utilities are not required to submit a substantial amount of information about the proposed rate adjustment or their operations when making an initial filing. Only when a wholesale customer objects will heightened PSC scrutiny be triggered.

c. PSC's response when wholesale customers withdraw their objections. In *Mount Sterling Water and Sewer Com'n, Case No. 95-193* (Ky.PSC Sep. 1, 1995), after initially suspending the city utility's rates upon the objection of its wholesale customers, the PSC approved the rates without further examination when the wholesale customers withdrew their objections.

In the case at bar, this purpose [purpose for PSC regulation] has been served. The affected public utilities made clear their objections to the proposed rate adjustment. Addressing the concerns of each public utility, Mount Sterling convinced each of the reasonableness of the proposed adjustment.

As the proposed rates on their face appear neither unreasonable nor unconscionable, the Commission sees no need to conduct further proceedings in this matter.

Id. at 1 – 2.

3. Regulator Role - PSC had held that municipal contracts should be considered in the same manner as the contracts of public utilities. The rate is examined for reasonableness and the contract is not controlling.

a. *Design and Use of System Development Charges, Administrative Case No. 375* (Ky.PSC Sep. 25, 2000) ("If a municipal utility's sales to public utilities are subject to Commission

regulation in the same manner as those of a public utility, then it possesses the same rights as a public utility.”)

b. [*City of Owenton, Ky.*, Case No. 98-283 \(Ky.P.S.C. Feb. 22, 1999\)](#) (“Assuming arguendo that the parties had reached some agreement upon cost methodology, such agreement is not binding upon the Commission. The Commission has “the right and duty to regulate rates and services, no matter what a contract provided.” [*Board of Ed. of Jefferson County v. William Dohrman, Inc.*, 620 S.W.2d 328, 329 \(Ky.App. 1981\)](#)). While the Commission should give weight to the intent of the parties, its ultimate obligation is to establish rates that are fair, just and reasonable.”)

c. [*City of Lawrenceburg*, Case No. 2006-00067 \(Ky.PSC Nov. 21, 2006\)](#). PSC rejected provision of wholesale contract that provides for an annual adjustment of wholesale rate based upon increases in the Consumers Price Index. PSC questioned the accuracy of the index as it applies to water service and the contract’s failure to provide for reductions in rate in the event of deflation.

d. [*City of North Middletown*, Case No. 2008-00051 \(Ky.PSC Feb. 13, 2008\)](#) (PSC finds that municipal utility has incorrectly calculated contract formula for passing through a water supplier’s increase and orders a larger rate adjustment than municipal utility requested to reflect the full cost of purchased water).

e. Under this model, the benefit of PSC jurisdiction may shift to a municipal.

(1) The PSC may permit rates that are in excess of those allowed by the water purchase contract but reflect the actual cost of service.

(2) Municipal utilities, unable to obtain agreement with wholesale customer to modify or amend contract, may seek unilateral amendment by filing new rate schedules or rules revisions with PSC and requesting PSC authorization to impose. Examples: Limits on purchase quantities; penalties for excessive purchases; requirements to submit information for system planning.

D. How far does PSC Jurisdiction Extend?

1. Rates charged to other municipal utilities. PSC has disclaimed any jurisdiction over the rates charged to other municipal utilities. See [Mount](#)

[Sterling Water and Sewer Com'n, Case No. 95-193 \(Ky.PSC May 31, 1995\)](#) at 1 (“The Commission’s jurisdiction over municipally owned utilities extends only to rates charged and services provided to public utilities. It does not extend to the retail rates of such utilities or to the rates which a municipally owned utility may assess to another municipally owned utility.”)

2. Non-Kentucky Municipal Utilities. [City of Williamson, West Virginia, Case No. 99-276 \(Ky.PSC Aug. 26, 1999\)](#) (held that PSC jurisdiction does not extend to an out-of-state municipal utility where the point of delivery of services is also outside of Commonwealth).

3. Territory disputes between municipal utilities and public utilities. See [City of Lawrenceburg v. South Anderson Water District, Case No. 96-256 \(Ky.PSC June 11, 1998\)](#) (held that PSC is not expressly authorized to address such issues).

4. Construction of new facilities. Is a municipal utility required to obtain a certificate of public convenience and necessity if its construction of new facilities will increase a public utility’s rates? See [City of Danville, Kentucky, Case No. 99-353](#) (issued raised but not resolved).

5. Service issues.

a. Service includes “any practice or requirement in any way relating to the service of any utility, including . . . the purity, pressure, and quantity of water, and in general the quality, quantity, and pressure of any commodity or product used or to be used for or in connection with the business of any utility.” KRS 278.010(13).

b. [KRS 278.200](#) mentions the “service standards.”

c. Issues falling within service standards.

(1) Quantity (including excessive consumption)

(2) Water Pressure

(3) Discontinuance of Service (including emergency shutdowns).

d. [Winchester Municipal Utilities, Case No. 2001-230 \(Ky.PSC Oct. 19, 2001\)](#). PSC struck certain provisions of wholesale contract related to meter testing that conflicted with PSC regulations. Held: To the extent that a municipal utility is subject to PSC jurisdiction, it must comply with PSC regulations.

- e. What regulations?
- E. When does PSC jurisdiction begin?
 - 1. Must be a contract between a municipal utility and public utility.
 - 2. Contract need not be in writing.
 - 3. *City of Greenup v. Public Service Commission*, 182 S.W.3d 535 (Ky.App. 2005) (PSC has the authority to review the circumstances at hand and determine if it had jurisdiction over the matter on the basis that a contract had been formed.

V. SUMMARY

- A. Dramatic swings of the pendulum since 1934.
- B. Key Concern: Protection of those lacking voting power (extra-territorial customers or county water districts).
- C. Legal foundations of Simpson County Water District are not stable and are subject to attack. If Louisville Water Company's approach to *Olive Hill* is any example, a sustained, long-term challenge to *Simpson County Water District* could result in same fate. Municipal and public utilities should not be totally dependent upon *Simpson County Water District* in developing their relationships with their customers or suppliers. Contingency planning is necessary.
- D. Possibility of legislative action should be considered.
- E. PSC's role continues to evolve. The full extent of PSC jurisdiction is being developed on a case-by-case basis.
- F. *Simpson County Water District* is a double-edged sword. If originally intended to protect wholesale water customers, it may also serve to protect municipal utilities by permitting the PSC to change existing contracts to ensure that fair and reasonable rates are established.